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before the
House Government Reform Subcommittee on
Government Management, Finance and Accountability
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Financial Report of the United States Government for Fiscal Year 2005

Mr. Chairman and Members of the Subcommittee:

I appreciate your inviting me here today to discuss the *Financial Report of the United States Government* for fiscal year 2005. The Treasury Department greatly appreciates your continued focus on improving the Federal Government's financial management and reporting. Your sustained attention to these issues highlights their importance and has led to significant improvements. Today I will briefly discuss the fiscal year 2005 financial results including the report's long-range, accrual-based look at the government's liabilities, commitments, and responsibilities. I will describe the actions we are taking to resolve the auditor's findings and recommendations and our plans to make the report more useful. Finally, I will tell you what I believe are the next steps we need to take in government financial reporting.

The annual financial report reflects Treasury's long-standing responsibility to provide the Congress and the public with financial information on the government's operations. Treasury has fulfilled its core responsibility to report on the nation's finances since Treasury Secretary Alexander Hamilton gave his first report to the Congress in 1790. Our intent is to give you, the Congress, and the public, a timely, reliable, and useful report on the cost of the government's operations, the sources used to fund them, and the implications of the government's financial commitments. The report is designed to encompass the financial results of all three branches of the federal government. We are constantly striving to improve how we carry out these responsibilities.

I'm pleased that this year, as in 2004, we were again able to issue this report on December 15. In addition, this year, all 24 CFO Act agencies published their audited financial statements by November 15. These much more timely submissions are evidence that both Treasury and the agencies have improved their processes, systems and data. While we have improved the timeliness of our reporting and made significant improvements in data reliability, we still have a long way to go. Once again this year, due to long-standing material weaknesses, GAO issued a disclaimer of opinion on the statements. Later in my testimony, I will discuss GAO's findings and recommendations in more detail and describe the steps we are taking to address them.

FY 2005 Results

As Treasury and OMB reported in October, the growing economy increased revenues to a level of \$2.2 trillion. This was nearly a 15 percent increase over the previous fiscal year and the largest year-over-year percentage increase in receipts in over 20 years. Consequently, the 2005 federal budget deficit of \$318 billion, as reported in the President's Budget, was lower than anticipated and lower than the 2004 deficit of \$413 billion. When expressed as a percent of Gross Domestic Product, the 2005 deficit was lower than the deficits in 16 of the last 25 years and was on track to meet the President's deficit-reduction goals.

We reported on December 15 in the Financial Report that the government's FY 2005 *net operating cost* was \$760 billion. The comparable net operating cost in 2004 was \$616 billion. Thus, while the budget deficit improved from 2004 to 2005, the net operating cost increased. The different amounts and trends stated for the budget deficit and the net operating cost stem from the different methods of accounting used for the two reports. The budget report is prepared on a cash basis, the Financial Report on an accrual basis. For FY 2005, the difference of \$442 billion between budget deficit and net operating cost is primarily due to actuarial increases in federal employee pension and health liabilities, and an increase in actuarial costs of veterans' benefits, due to changes in assumptions in Veterans Affairs' actuarial model that calculates the liability. Examples of some of these assumptions are: the number of veterans and dependents receiving payments, discount rate, cost of living adjustments, and life expectancy.

Reconciliations of Net Operating Cost and Budget Deficits

(In billions of dollars)

	2005	2004
Net Operating Cost	(\$760)	(\$616)
Changes:		
Veterans' benefits liability	198	(30)
Federal employee benefits	232	212
Increase in capitalized assets	(36)	(3)
Other, Net	<u>48</u>	<u>24</u>
	<u>442</u>	<u>203</u>
Budget Deficit	<u>(\$318)</u>	<u>(\$413)</u>

In preparing the Financial Report's statement of net cost, Treasury makes consolidating entries and cost allocation adjustments to individual agency results in accordance with generally accepted accounting principles (GAAP). Two of the largest of these adjustments are financial transactions between agencies and retirement benefits managed by the Office of Personnel Management. Transactions between agencies, internal to the government as a whole, are viewed as double counting under GAAP and must be eliminated so that only the net results are shown on the government's statements. The retirement benefits managed by OPM relate to the agencies where employees worked during their career. Accordingly, standards require that we allocate these costs to the agencies to better reflect each agency's full costs. The attached schedule, Appendix I, shows these adjustments.

Summary of Social Insurance Responsibilities

In addition to reporting the financial results of the past year, the Financial Report provides information on our long-term financial commitments and obligations. One important measure of the government's fiscal position is the present value cost of its responsibilities for social insurance programs, primarily Social Security and Medicare. Including these future financial responsibilities in this report gives a more complete look at the government's finances. This information is presented in the report on the Statement of Social Insurance, which will be a primary statement subject to audit in the FY 2006 report.

Each year, the Social Security and Medicare Trustees report on the current financial status of those programs and provide 75-year projections of program income and expenditures. The latest set of projections from the Trustees shows that the 75-year present value of Social Security and Medicare obligations for the Federal Government is \$35.6 trillion. I have attached a summary table of the projections as Appendix II.

The trustees project that costs for Social Security and Medicare, relative to GDP, will increase sharply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the large baby-boom generation retires. Thereafter, growth in Social Security costs will be slower, but will continue to increase due primarily to projected increasing life expectancy. Medicare costs are projected to continue to grow rapidly due to expected increases in the use and costs of health care.

Addressing the Auditor's Findings

As I mentioned earlier, due to long-standing material weaknesses, GAO was unable to express an opinion on the statements. I recognize that until our statements can withstand audit scrutiny, we will not benefit from the report's full value in informing the Congress and the public of the government's fiscal position. We are in agreement with GAO on these principal material weaknesses:

- (1) serious financial management problems at the Department of Defense,
- (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies,
- (3) the federal government's ineffective process for preparing the consolidated financial statements.

GAO raised many valid points in their audits, and there is no one who would like to see us get a "clean" audit opinion on this report more than I would. Across government, we have been addressing these challenges, and we are making progress. The Department of Defense is making headway in improving its systems to correct its financial reporting problems; however, this will be a long, time-consuming effort. In addition to Defense, Homeland Security and NASA also have some significant financial issues.

The Department of Homeland Security, when it was organized, brought together 22 agencies, all, for the most part, having their own financial systems. Consequently DHS faces some large financial management challenges, but it is making progress. NASA, which has had weaknesses in internal control procedures and processes related to property, plant and equipment, has made significant progress in FY 2005 in correcting some internal control weaknesses, but still has much to do to resolve this issue.

We concur with GAO that a significant material weakness is the out-of-balance condition that results from intragovernmental transactions, when two agencies record and report differently on a transaction between the two. We are addressing this issue in several ways. First, we are requiring significantly greater detail from the agencies, and we have developed a new tool to track the imbalances, point out where problems exist, and help us better analyze the data. Surprisingly, we discovered that many of the largest differences occur when two agencies record a statutory transfer of budget authority and funds between them. Also, when two agencies conduct business with each other as *trading partners*, they sometimes record and report the same transaction differently.

Second, partnering with OMB, we developed reports that show these inter-agency transfers throughout the government. We find that agencies use these reports, which we post on the web, to analyze their transfers. Third, we brought the agencies together to discuss these matters under the auspices of the Chief Financial Officers Council. Fourth, we have been working with the CFO Council to develop new “business rules” for these intragovernmental transactions, and we believe these new rules will help bring about more consistent accounting transactions. Finally, we required agency auditors to review the out-of-balance condition between their agency and its trading partners in the hope that greater auditor involvement will encourage the agency to accurately record these transactions and correct these imbalances. We plan on expanding these auditor reviews to further assist agencies in resolving their differences, some of which are of long standing.

Regarding GAO’s findings and recommendations on the report preparation process, we continue to take steps to address these. We have developed detailed corrective actions plans and are addressing the material weaknesses. Some of the individual plans have solutions which are or will be implemented in a short time period while others will take longer than a year to resolve. Treasury continues to meet with GAO regularly to discuss the findings and recommendations in detail.

This past year, we initiated a process to formally communicate to GAO the recommendations that we believe are closed, and we will continue the dialogue with GAO on these issues. In recent discussions with GAO, we agreed to supplement this process with additional documentation to provide the level of assurance GAO requires to close out the recommendations. This year GAO closed out over 20 outstanding recommendations, and they will continue to evaluate the documentation and analyses provided by Treasury on open recommendations.

This is the second year that the Financial Management Service (FMS) has used the Governmentwide Financial Report System (GFRS) to prepare the report. GFRS is an internet application designed to directly link data from agencies' financial statements to the corresponding line items in the Financial Report. Prior to this, the financial information came from other Treasury financial systems that may or may not have tied to the agencies' audited financial statements. GFRS, through a closing package process, requires the agencies to reclassify the financial statement line items from their audited financial reports to the corresponding line items in the Financial Report. It provides the agencies the opportunity to take the responsibility for how their data should be properly consolidated. It also requires the agencies to provide additional financial disclosure information and stewardship information crucial to understanding and supplementing the content of the primary statements.

In developing GFRS, FMS considered and implemented GAO's audit findings on the preparation process. Some findings were specifically related to the manner in which GFRS captured information from the agencies. To address this, FMS modified GFRS to improve the data entry and linkage by the agencies to their audited financial statements. To address recommendations on policies and procedures for GFRS and the resultant compilation process, FMS improved the instructions to the agencies in the Treasury Financial Manual and its internal policies and procedures related to internal control, documentation and management review.

FMS made other improvements in the 2005 process. One of these was accelerating by three days the collection of the budgetary financial information. Also, using lessons learned during the 2004 reporting process, FMS implemented two key processes to ensure agency reporting success in 2005. FMS staff were available after normal working hours to answer agency questions and resolve system problems.

FMS also developed and used new analytical tools to specifically identify potential reporting errors and non-submissions and provided timely feedback to the agencies. All the agency preparers met their November 16 deadline for submitting the data, and agency IGs met the November 18 deadline to opine on the data submitted in GFRS. Evidence of the success of GFRS implementation is that agencies were able to submit their data earlier than in the prior years, and this enabled FMS to compile and transmit the Financial Report to the auditor within 10 days of receiving the agency financial information in GFRS.

Finally, many of GAO's findings related to the note disclosures in the report. As I testified last year, the Federal Accounting Standards Advisory Board (FASAB) undertook a project to provide explicit consideration of disclosures tailored to the financial report and specifically related to standards issued prior to January 2003. As a result, FASAB has issued an exposure draft that proposes tailored disclosures that would enhance the financial report's usefulness to the public and be consistent with a general purpose report. The proposed standard would require that the report direct readers to the individual agency financial reports for extensive disclosures that are not viewed as appropriate at the governmentwide level. We expect that if the exposure draft becomes a standard, it will resolve many of the remaining findings

Making the Report More Useful

We have improved our preparation process and are producing more timely reports. Because we had to produce the reports within these accelerated timeframes, we all had to improve our processes and in many cases, our systems. While the acceleration in and of itself improves government reporting, we now must ask whether our financial reports are useful to Congress, to agency heads and other decision makers and whether they serve as a useful and informative report to the citizens.

We recently reached outside Treasury for suggestions and ideas for improving the governmentwide report. We sought advice from the Government Accountability Project at the Mercatus Center at George Mason University and also from the Partnership for Public Service, and we have incorporated several of their suggestions in the 2005 report. In January, we held a roundtable discussion with Congressional staff, public accounting professionals, analysts from credit rating agencies, economists and interested members of the public to ask their advice on possible report improvements.

We received many excellent suggestions and are reviewing them to see how we can prepare a better, more useful report. We are already exploring one suggestion to offer a shorter, more understandable summary report.

Clearly, if we want to publish government financial information that is used more broadly, not just by the dedicated reader, we need to do some things differently. The first question we need to ask is, “Who is our audience?” That answered, we need to think seriously about what we have in the report that is of value to them. We must then act to provide them with a better product and service. I welcome this challenge and am committed to doing this.

Outlook for Federal Reporting

I am also committed to working with OMB and the Chief Financial Officers Council on developing the government’s financial management strategy for the near future. The improvements in financial systems and business processes that many agencies have made as a result of audited statements and accelerated timelines has led to better underlying financial data. We are now looking toward improving efficiency through standard systems and processes and a common language and structure for exchanging information and financial data among agencies and between agencies and Treasury.

To better focus on the objectives it wants to achieve, the CFO Council has just changed its committee structure and organized along lines that will transform federal financial management. Among these are modernizing systems and increasing standardization across the government through standard processes, interfaces and data. The goal is to improve financial management, increase efficiency, and also to reduce costs through the use of shared service providers. Closer to home, I will co-chair a transformation team that will examine Treasury reporting issues, both budgetary and financial. I believe that this effort will not only lead to near-term efficiencies, but will also set the stage for changes over the longer term.

Agencies are also putting in place improved internal controls, which are essential for improving data reliability and fostering improved reporting and accountability. All agencies are now operating under a stronger governmentwide policy to establish, assess and report on internal controls.

The objectives are to achieve effective and efficient operations, reliable financial reporting, and compliance with laws and regulations. The improved systems and processes and better internal controls should help reduce restatements and lay the groundwork for further improvements and efficiencies. These enhanced processes can serve as the base of opportunity for more frequent financial reporting, development of cost accounting data useful to program managers and decision makers, and other advanced financial management practices.

In conclusion, I believe we have come a long way, but we still have a long way to go. Our upcoming challenges are significant but manageable, and I am confident that we will continue to see real progress. Thank you.

Appendix I

Consolidation of Net Costs in the Financial Report of the U.S. Government for the Year Ended September 30, 2005 (in billions of dollars)

	Agency Net Cost	Adjust- ments	Intra- Gov. Elim	Imputed Costs	Pension & Health Allocation	FR Net Cost
Department of Agriculture	\$91.0	-	\$(5.2)	\$0.7	\$6.2	\$92.7
Department of Commerce.....	6.3	-	(0.8)	0.2	2.0	7.7
Department of Defense.....	634.9	-	0.4	4.5	37.2	677.0
Department of Education	75.2	-	(4.8)	-	0.5	70.9
Department of Energy.....	40.9	0.6	(3.9)	4.2	1.3	43.1
Department of Health and Human Services	581.3	-	(1.0)	0.3	3.2	583.8
Department of Homeland Security	66.4	-	(2.7)	0.7	3.5	67.9
Department of Housing and Urban Development.....	40.4	-	1.0	0.1	0.8	42.3
Department of the Interior	13.4	-	(1.4)	0.5	3.8	16.3
Department of Justice	24.3	(0.2)	(3.0)	0.7	4.7	26.5
Department of Labor	50.4	0.5	2.0	(4.0)	1.1	50.0
Department of State	12.0	(0.1)	0.5	0.1	1.1	13.6
Department of Transportation	56.9	-	(1.9)	0.5	6.3	61.8
Department of the Treasury	364.9	(125.9)	(166.3)	-	6.5	79.2
Interest on Treasury Securities held by the public.....	-	181.2	-	-	-	181.2
Department of Veterans Affairs.....	263.4	-	(1.7)	1.4	10.1	273.2
Agency for International Development	12.3	0.4	-	-	0.1	12.8
Environmental Protection Agency	8.0	-	(0.5)	0.1	1.3	8.9
General Services Administration.....	(0.8)	-	(0.4)	0.1	0.9	(0.2)
National Aeronautics and Space Administration	15.2	-	(0.4)	0.1	1.5	16.4
National Science Foundation	5.4	-	-	-	0.1	5.5
Nuclear Regulatory Commission.....	0.1	-	(0.1)	0.1	0.3	0.4
Office of Personnel Management.....	63.6	-	70.0	(11.1)	(103.8)	18.7
Small Business Administration.....	0.8	0.1	(0.2)	-	0.3	1.0
Social Security Administration.....	568.2	2.3	(1.4)	0.5	4.5	574.1
All Other Non-CFO Act Entities.....	<u>21.3</u>	<u>8.4</u>	<u>(11.5)</u>	<u>0.3</u>	<u>6.5</u>	<u>25.0</u>
Total	<u>\$3,015.8</u>	<u>\$ 67.3¹</u>	<u>\$(133.3)</u>	-	-	<u>\$ 2,949.8</u>

¹ Includes adjustments for Earned Income Tax Credit (EITC), \$40 billion and Child Tax Credit, \$15 billion.

Appendix II

Social Security and Medicare Programs Present Values of Future Expenditures less Future Revenues (75-year projections)

(in billions of dollars)

Program – (Trust Fund)	<u>2005</u>	<u>2004</u>
Social Security (Fed. Old-Age, Survivors & Disability Ins.)	\$5,704	\$5,229
Medicare Part A (Fed. Hospital Insurance)	8,829	8,492
Medicare Part B (Fed. Supplementary Medical Insurance)	12,384	11,440
Medicare Part D (Fed. Supplementary Medical Insurance)	<u>8,686</u>	<u>8,119</u>
TOTAL	\$35,603	\$33,280

Source: 2004 and 2005 Social Security and Medicare Trustees Reports